



May 2, 2005

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th and C Streets, N.W.
Washington, DC 20551

Re: Comments to Proposed Amendments To Regulation CC
Docket No.: R-1226

Dear Ms. Johnson:

The Electronic Check Clearing House Organization ("ECCHO") is a not-for-profit national clearinghouse dedicated to promoting electronic check collection and related payment system improvements. Membership in ECCHO is available to any depository institution, as defined by the Federal Reserve Act, and various membership classes are available to serve banks from the very smallest to the very largest. ECCHO's current membership consists of approximately 20 banks from across the United States representing approximately 60% of the total deposits of the nation's banks.¹

ECCHO is pleased to provide the Federal Reserve Board (the "Federal Reserve") with comments to the proposed regulation (the "Proposal") to amend Regulation CC to provide a new warranty for "remotely created checks" or "RCCs." Our comments are set forth below.

1. Application of RCC Warranty to Consumer and Business RCCs.

We support the current approach in the Proposal that applies the RCC warranty to RCCs that are drawn both on consumer accounts and business accounts. While we do not have statistical information on the usage of consumer RCCs compared to business RCCs, we believe that most of the RCCs in the market today are drawn on consumer accounts. However, there is no reason for limiting a paying bank to making a claim under the RCC warranty for RCCs drawn only on consumer accounts. In both cases, it is equally appropriate for the depository bank to bear the risk of loss for unauthorized RCCs, as the depository bank is best positioned to deter abuses of RCCs. Moreover, as an operational matter, it will be more efficient for banks to treat both consumer and business RCCs the same for claims and adjustment processing.

2. Definition of "remotely created check" under the Proposal.

¹ The views expressed in this letter do not necessarily reflect the views of each ECCHO member bank. Many of the ECCHO member banks may be submitting their own comments on this Regulation CC proposal.

We have a number of comments regarding the definition of "remotely created check" under the Proposal. We have set forth our comments below, including a suggested revision to the definition of RCC to address certain of these comments.

A. Creation of RCC By Payee.

The Proposal definition of RCC requires that the RCC be "created by the payee." The Commentary to the definition states that an RCC created by an agent of a payee would be deemed to have been created by the payee for purposes of this definition. We are concerned that this definition could introduce two uncertainties as to the application of the warranty. First, it is not clear how a paying bank could determine from examining the RCC, or from even contacting its drawer customer, whether or not a particular RCC was created by the payee or its agent. This could result in disputes between the paying bank and the depository bank as to whether or not the RCC warranty was potentially applicable to the RCC.

Second, we are aware that there are some RCCs that are created by persons other than the payee or the payee's agent. For example, in the bill payment context, a customer may contract with a third party bill payment company to provide the customer with bill payment services. Some of these bill payment services complete the bill payment by printing an RCC made payable to the payee, and sending it to the payee for payment of the customer's bill. In that situation, the RCC is created by the customer's agent, not the payee's agent. We believe that it is appropriate to have the same RCC warranty protection apply to this type of RCC as apply to an RCC that is created by the payee.

We also note that the above recommendation is consistent with the approach taken in the recent revisions to UCC Article 3 (the "UCC Revisions") to address RCCs under the UCC. The UCC Revisions define a "remotely-created consumer item" as an item "which is *not created by the payor bank* and does not bear the handwritten signature purporting to be the signature of the drawer." (Emphasis added).²

B. Signature of the Payee.

The current definition of RCC in the Proposal states that an RCC does not "bear a signature in the format agreed to by the paying bank and the customer." We recommend that the Federal Reserve consider revising this signature element of the definition. As an alternative, we support an approach consistent with the UCC Revisions. The UCC Revisions define a "remotely-created consumer item" as an item "which is not created by the payor bank and *does not bear the handwritten signature purporting to be the signature of the drawer.*" (Emphasis added). We believe that this approach to excluding signed items from the definition of RCC more clearly delineates between an RCC subject to the proposed new

² This recommended approach also is consistent with California's definition of "demand draft," which is a "writing not signed by a customer that is *created by a third party* under the purported authority of the customer for the purpose of charging the customer's account with a bank." Cal. Commercial Code, Section 3104(k).

warranty and a check containing a fraudulent or unauthorized signature of the customer which is not subject to the RCC warranty.

As a related matter, we recommend that the definition under the Proposal not include a requirement that the signature of the customer be "handwritten" as is required in the analogous definition in the UCC Revisions. Since the RCC warranty in the Proposal should extend to business RCCs, it is appropriate to include within the definition of RCCs those items that have neither a handwritten signature nor a facsimile signature.

C. Suggested Revisions to Definition.

Below is a suggested revision to the definition of RCC in the Proposal to implement the above two comments.

Section 229.2(fff): "Remotely created check" means a check that is drawn on a customer account at a bank, is not created by the paying bankee, and does not bear a signature purporting to be the signature of in the format agreed to by the ~~paying bank and the customer.~~

D. Coverage of Payable-Through Checks Under Definition of RCC.

The Proposal does not specifically address whether or not the definition of RCC is intended to include those checks that are payable-through a bank and drawn on another bank or a non-bank payor. It is unclear from the text of the current definition of RCC in the Proposal whether payable-through checks are covered under the definition of RCC. This is because it is not clear whether for purposes of this definition a payable-through check is "drawn on a customer account at a bank," and because payable-through checks generally do not bear the signature of the customer of the payable-through bank. (We note that the UCC Revisions and the state demand draft laws of which we are familiar also do not specifically address payable-through checks.)

As a general policy matter, we believe that the payable-through checks which are not signed by the drawer customer of the bank/non-bank payor should come within the definition of an "RCC," and should have the benefits of the RCC warranty. The bank/non-bank payor cannot review a customer signature on such checks, and therefore the payor should have recourse to banks that transferred the check to it. Accordingly, we recommend that the Federal Reserve revise either the definition of an RCC or the related Commentary, in a manner consistent with the revisions proposed in Section 2.C of this letter, to include checks payable-through a bank as within the definition of an "RCC."

E. Alternative Approach on Definition of RCC

In the event the Federal Reserve does not agree with the substance of the above suggested revisions to the definition of RCC, ECCHO would support consideration by the Federal Reserve of revising the definition of RCC in the final rule to be consistent with the

definition of "demand draft" under the laws of California and other states that have adopted an authorization warranty for these type of items under their UCCs. This approach to the definition of RCC in the final rule would provide a consistent statutory definition for these types of items under federal and state law.

3. Definition of Customer Account.

We request that the Federal Reserve consider providing additional Commentary to Section 229.2(fff) regarding the term "customer account" as used in the definition of RCC. The Commentary should state that the term "customer account" for these purposes includes accounts other than a traditional checking account, such as the following types of accounts on which an RCC could be drawn: (i) any customer asset account at a bank, (ii) customer credit accounts, and (iii) the bank's own accounts, such as accounts used by the bank to pay official checks and teller's checks. This Commentary is necessary to ensure that the RCC warranty applies to the full range of possible RCCs. It may be possible for a payee to create an RCC that is drawn on a credit account of the customer, such as a credit card account, that uses paper drafts to access the credit. For example, a customer could give the numbers from the bottom of a credit card convenience check to a payee for use in the creation of an RCC. Similarly, a fraudster could use the account numbers from an official check or a teller's check to create an RCC that is drawn on an account of the bank.

4. Warranty for RCCs.

A. *Scope of Warranty.*

Under the Proposal, the new RCC warranty under Regulation CC would provide that the RCC must be authorized by the customer "according to the terms stated on the check." We support this broad authorization warranty for RCCs, and believe that the RCC warranty should require that the name of the payee and the dollar amount be consistent with the customer's authorization. We believe that the warranty for RCCs set forth in the UCC Revisions -- limited to the amount of check and authorization for issuance -- is too narrow. We request that the Federal Reserve consider adding guidance in the Commentary that provides a further explanation of the full scope of the RCC warranty. For example, the Commentary could give an example of how the RCC warranty would apply in a situation where the name of the payee varies from the name of the payee as identified to the customer in the context of the authorization. Such a situation can occur when the payee's trade name is used in the customer authorization process, but the payment is completed under the legal name of the payee.

We also recommend that the definition of RCC be revised to state that the RCC must be authorized by the customer according to the terms stated "on the face" of the check. We believe that limiting the authorization to the terms "on the face" of the check more clearly delineates the scope of the RCC warranty. For example, this change would make it clear that any information on the back of the RCC, such as an indorsement, is not relevant to the application of the warranty. This "on the face" approach also is consistent with the approach

taken for the demand draft warranty under certain states' non-uniform amendments to the UCC.³

B. Situations Not Covered Under Warranty.

We recommend that the Commentary to the final rule address two situations in which the RCC warranty should not apply. First, the RCC warranty should not extend to a claim by the customer that an RCC was unauthorized because the agreed payment period varies from the date on the RCC or from the date of actual payment of the RCC by the paying bank. For example, if a drawer customer seeks a recredit from the paying bank because the customer alleges that he or she had authorized the RCC to be issued only after a certain date. The existing rules under the UCC on payment of stale or post-dated checks should apply to RCCs in the same manner as traditional checks. Extending the RCC warranty to the date on the RCC will add to confusion regarding the application of the RCC warranty. There are reasons outside of the control of the paying bank and the depository bank as to why an RCC may be collected in a time period that is inconsistent with the date of the check or the customer's authorization. For example, the payee may hold the RCC for a period of time before depositing the RCC.

Second, we recommend that the Commentary to the final rule clarify that the RCC warranty does not extend to situations of "buyer's remorse." The discussion section to the Proposal makes a reference to a customer having "buyer's remorse" with respect to a purchase that is paid with an RCC. However, there is nothing in the Commentary to the Proposal that would indicate that the RCC warranty would (or would not) extend to a situation where a customer has claimed a payment was unauthorized because of buyer's remorse. We believe that the RCC warranty should not permit a paying bank to make a warranty claim to a depository bank in a situation where the paying bank has accommodated its customer with a recredit of a check payment in the event of buyer's remorse. Accordingly, we request a clarification in the Commentary that the RCC warranty would not extend to a situation in which the customer has sought to refuse payment of an RCC because of buyer's remorse, where the RCC is otherwise authorized according to the terms on the face of the RCC.

Suggested Commentary Text

Section 229.34(d)-# An RCC is not unauthorized for purposes of the RCC warranty in situations where the paying bank has credited its customer's account for an RCC because: (i) the date on the RCC was inconsistent with either the date agreed to by the customer and the payee for payment of the goods or services or the date agreed for the issuance of the RCC; or (ii) the customer alleged that the goods or services provided were not consistent with the terms of the purchase or otherwise has a dispute with the merchant regarding the goods or services.

³ For example, under the California Commercial Code, the warranty for demand drafts provides that a "person who transfers an instrument for consideration warrants...[i]f the instrument is a demand draft, creation of the instrument according to the terms *on its face* was authorized by the person identified as drawer." Cal. Commercial Code, Section 3416.

C. Defenses of Transferring Bank to Warranty Claim.

The final rule and/or the related Commentary should address what defenses, if any, that a transferring bank could raise against a claimant bank that brings an RCC warranty claim against the transferring bank.

We request that the Federal Reserve revise the final rule or the related Commentary to permit a transferring bank to raise a defense against an RCC warranty claim made by a claimant bank that is based on the actions of the drawer customer, the claimant bank or other person making the claim. This approach would be analogous to UCC Section 4-208(c) that permits a transferring bank to raise a defense to a UCC presentment warranty claim brought by a claimant bank by proving that the drawer customer of the check is precluded under UCC Sections 3-406 or 4-406 from asserting against the claimant bank a claim of unauthorized indorsements or alteration. In the context of the RCC warranty claim, the final rule would state that a transferring bank may raise as a defense against a claim of a claimant bank the fact that the drawer customer or other claiming person was precluded under UCC Sections 3-406 or 4-406 from claiming that the RCC is unauthorized. For example, if a drawer customer fails to reasonably promptly examine his/her account statement to determine an unauthorized RCC, such that the claimant bank would have a defense to payment under Section 4-406 of the UCC, the transferring bank should be permitted to raise that defense against the claimant bank. We believe it is appropriate to allow the transferring bank to raise these types of defenses to the RCC warranty claim because otherwise a claimant bank will have no incentive to raise its own defense against a drawer customer that seeks a recredit for an RCC.

As a related matter, we request that the Federal Reserve clarify in the Commentary to Section 229.34(d) that the transferring bank could raise a defense of comparative negligence under Regulation CC against the claimant bank that brings an RCC warranty claim. This comparative negligence defense would arise under Section 229.38(c) of Regulation CC. For example, a claimant bank may recredit its customer's account after the customer alleges an unauthorized RCC, but the bank then holds the RCC for three months before making the claim to the transferring bank. If the transferring bank could show that it would have been able to recover the amount of the RCC from its depositor customer had the claimant bank made the RCC warranty claim on a more timely basis, the transferring bank would have a defense to the RCC warranty claim.

Finally, we anticipate that the Federal Reserve's Operating Circular and private sector check clearinghouse rules would set forth the procedures and processes for a claimant bank to make an RCC warranty claim to a presenting/depository bank. For example, clearinghouse rules and/or the Operating Circular could establish a process for payment of certain RCC warranty claims by means of settlement entry. We are aware that some check clearinghouses today have existing rules that establish procedures for processing warranty claims (arising under state law or clearinghouse rules) for demand drafts.

D. Application of Warranty To Customers.

As set forth in the Proposal, the warranty for RCCs only applies between banks in the check collection process, and does not extend to a claimant bank's customers. This is a reasonable approach because the claimant bank's customer is currently protected against liability for an unauthorized RCC under the existing protections in the Uniform Commercial Code. The proposed RCC warranty addresses the problem with RCCs today in that the claimant bank frequently absorbs losses associated with unauthorized RCCs, but has no recourse over the entity that submitted the RCC into the check clearing system. Accordingly, we support the current scope of the RCC warranty as set forth in the Proposal.

5. Alternatives to RCC Warranty.

The Federal Reserve asked for comment in the Proposal on possible alternatives to the new warranty for RCCs. As indicated above, we support the proposed warranty for RCCs as set forth in the Proposal, with the modifications requested in this letter. Accordingly we do not offer any different alternatives to the warranty approach set forth in the Proposal.

The Federal Reserve did identify two alternatives in the Proposal: (i) extending the midnight deadline for RCCs, and (ii) waiting for additional states to adopt the UCC revisions addressing RCCs. We do not support either of these two identified alternatives. With respect to extending the midnight deadline, we believe that this alternative would raise issues of finality of payment and possible other unanticipated results. In addition, in order to be effective, this alternative would require that the midnight deadline be extended for a long period of time, further extending uncertainty about whether final payment has occurred. It is possible that a bank may not learn of an unauthorized RCC until a number of months from the date of payment. By comparison, the RCC warranty approach provides protection to the paying bank for up to one year. We recognize that there may be some support in the industry for a process to handle these RCC warranty claims, which are typically small dollar amounts, on a settlement entry basis. However, we do not support extending the midnight deadline in order to allow these warranty claims to be handled as returns in the settlement process. Rather, we support the development of procedures under clearinghouse rules and Operating Circular 3 for the Federal Reserve Banks that would allow all or some of these RCC warranty claims to be handled as claims but through return-like processes and with settlement entry. One example of how to accomplish this is Rule 8 of the Uniform Paper Check Exchange Rules.⁴

⁴ Under Rule 8, which has been adopted by certain check clearinghouses in the United States, a paying bank may make a warranty claim against a depository bank for an unauthorized remotely-created check. Rule 8 states that the paying bank "may make a warranty claim" by "delivering such check to the clearinghouse or the depository bank for settlement, in accordance with the clearinghouse's rules for returned checks." While the claim is processed through the return settlement process, the delivery of the check to the clearinghouse, and ultimately the depository bank, is not a "return" of the check under the UCC or Regulation CC.

We also do not support waiting for additional states to adopt the UCC Revisions addressing RCCs. Given the experience with other UCC amendments and the UCC amendments addressing RCC specifically, it cannot be anticipated that a critical mass of states will enact the UCC amendments addressing RCCs in the reasonable distant future. Also, as discussed above, we view the Proposal as an improvement over the UCC amendments in many respects.

6. MICR Line Identification of RCCs.

The Federal Reserve requested comment in the Proposal on whether there should be a specific identifier of RCCs in the MICR line. For the reasons stated below, we do not support establishing new codes in the MICR line to identify RCCs.

There are only a limited number of available spaces in the standard MICR line and a limited number of codes for such available free spaces. These limited spaces/codes sets for the MICR line should be reserved for other check products and services that have a greater need for MICR line identification. In the case of the RCCs, there is no expressed need for the MICR line identification. The paying bank and other banks that receive the RCCs would be sufficiently protected against loss by the proposed new RCC warranty.

There are also practical problems and cost issues with using Position 44 to identify RCCs. It is understood that there have been issues with false reads and mis-reads in that position, and these mis-reads may be compounded by the fact that most RCCs are six inch size checks, as opposed to the longer business size checks used for substitute checks. This single digit position can only accommodate up to 10 values and 5 are already in use. Some of the values are more difficult to read than others. In terms of cost issues, banks would incur substantial costs to make the necessary systems changes to encode and verify MICR lines of RCCs. These system changes would need to be made to check sending, check receiving and even return processing. These system change costs are not justified, given the protections that are provided to a receiving bank under the proposed RCC warranty.

If the Federal Reserve considers the use of a MICR line identifier for RCCs, the Federal Reserve should use the minimum number of codes possible. We disagree with an approach that would use four MICR line identifiers to identify the RCC separately in the forward and return process, and to identify substitute check RCCs in the forward and return process. If the Federal Reserve chooses to require MICR line identification of RCCs, it should only require the use of two values: one for an original RCC and one for a substitute check of an RCC. The identification of RCCs for unpaid returned items, whether original checks or substitute checks, is not needed. Once an RCC is received and identified by the paying bank, there is no need to identify that item as an RCC in the qualified return process. The only organizations that handle qualified returns are Returning Banks (mostly the Federal Reserve) who will pass the item to the BOFD. The BOFD will de-strip the qualified return, and if there is a need to know it was an RCC the original code would still be on the item. If a specific code is needed to identify that an RCC is a substitute check and it is returned with the "5" in Position 44 to identify an unpaid returned substitute check, the qualified strip will be eliminated and again the BOFD would know that the original item was an RCC.

If the Federal Reserve considers the use of a MICR line identifier for RCCs, the Federal Reserve also would need to address in the final rule what enforcement mechanism will be used to ensure that creators or transferors of an RCC will properly encode the MICR line with the new identifier. For example, would the failure of a presenting bank to ensure that the RCC is encoded properly automatically result in an RCC that is "unauthorized" and subject to the warranty claim by the paying bank? The additional complexity that would accompany a necessary enforcement mechanism for the MICR line identification of RCCs is another basis for our opposition to any requirement in the final rule for a MICR line identification of RCCs.

7. General Characteristics of RCCs.

The Proposal requested comment on general characteristics of RCCs in use today in the check payment system. Generally, RCCs can be used in many of the same payment situations as ACH debit transactions. As noted in the Proposal, RCCs are frequently used in telemarketing transactions and bill payment transactions. There are a number of reasons why these transactions have remained or have become RCCs instead of ACH transactions. For example, some banks do not accept ACH transactions and some accounts do not accept the posting of electronic debits. In other situations, the RCC is used if it will clear faster than the ACH transaction. In other situations, some companies do not have the capability to create ACH transactions, but do have the capability to create RCCs.

The earliest large volume usage of RCCs was in the area of Preauthorized Checks (commonly called "PACs"). These payments, usually monthly insurance premiums, were preauthorized and recurring with written authorizations obtained from the customer. In the early days of this service, originators would send "No Signature Required" letters to the bank of the drawee to be filed in the customer's records in the event the payor bank needed to perform a signature verification.

In recent years, many checks are being converted to ACH transactions through the ARC service. In some situations, an originated ACH transaction will be returned and cannot be collected via the ACH. These administrative returns are typically converted to RCCs and collected by the merchant through the paper check system. The merchant has typically obtained the customer's authorization for both the ARC transaction and the subsequent creation of the RCCs in the event of return. Also in recent years, some bill payment services move money directly from the customer's account to the merchant's account by creating an RCC drawn on the customer's account and payable to the merchant.

We do not have any data on the annual number of RCC transactions today. However, the volume number is assumed to be relatively small and will continue to remain small.

8. Transition Period For Final Rule

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In the event that the Federal Reserve determines to amend Regulation CC to include a new RCC warranty, we request that the final rule have a delayed effective date of at least six months. This delayed effective date will give the financial services industry appropriate time to develop new procedures for handling warranty claims, to update customer agreements as appropriate, to revise clearing house rules as needed, and to educate large users of RCCs regarding the impact of new inter-bank warranty. If the Federal Reserve requires MICR line identification of RCCs in the final rule, the financial services industry would need an even longer delayed effective period, greater than six months, to make the necessary system and procedure changes.

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ECCHO very much appreciates this opportunity to comment on the Proposal. In the event of any questions concerning this letter or if ECCHO can be of further assistance to the Federal Reserve in its consideration of the Proposal, please do not hesitate to contact me at (214) 273-3201.

Sincerely,

A handwritten signature in cursive script, appearing to read "David Walker".

David Walker
President